

1 UNITED STATES BANKRUPTCY COURT  
2 SOUTHERN DISTRICT OF NEW YORK  
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3 In re: Chapter 11  
4 HOSTESS BRANDS, INC., 12-22052-rdd  
5 Debtors.

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8 MODIFIED BENCH RULING ON MOTION OF THE ACE COMPANIES  
9 TO COMPEL ARBITRATION RELATED TO DEBTORS' CASH COLLATERAL  
10 MOTION

10 **APPEARANCES:**

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1 HON. ROBERT D. DRAIN, UNITED STATES BANKRUPTCY JUDGE:

2 The debtors in this case filed a motion, dated November 5,  
3 2012, for authority to use cash collateral of ACE American  
4 Insurance Company pursuant to section 363(c) of the  
5 Bankruptcy Code, and, as applicable, sections 361 (dealing  
6 with adequate protection) and 105.

7 The motion was adjourned on consent to January  
8 2013. However, in the meantime ACE has moved to compel  
9 arbitration of what it terms a contract dispute underlying  
10 the debtors' cash collateral motion. And it is that motion  
11 to compel arbitration that is presently before me.

12 The reply brief submitted by ACE succinctly  
13 summarizes the facts. Pursuant to prior agreements, which  
14 have been, by order of the Court, assumed (and I'm  
15 compressing a lot into that phrase, because the orders  
16 themselves are important and affect the interpretation of  
17 the agreements), the debtors have agreed to provide the cash  
18 collateral to the ACE Companies for purposes of securing  
19 their obligations under the agreements, including the  
20 agreement to pay deductibles, that the debtors owe to the  
21 ACE companies under their insurance program.

22 Those obligations continue to accrue, although the  
23 policies have now been replaced or expired, because,  
24 obviously, there's a continuing expectation that injuries  
25 covered by the policies will manifest themselves.

1 ACE asserts, simply, the collateral was provided  
2 pursuant to the collateral agreement, the collateral secures  
3 their obligations under the collateral agreement, the  
4 collateral agreement, in Article 4, expressly requires the  
5 debtors to continue to provide collateral until ACE  
6 determines that there is no longer any need for such  
7 security, before the calculation of the insurance  
8 obligation, as defined in the collateral agreement, and that  
9 calculation may only be determined by interpreting the  
10 collateral agreement. Therefore, ACE contends, the motion  
11 contemplates a breach of the collateral agreement, and,  
12 therefore, ACE contends, that breach, or that dispute, must  
13 be arbitrated under the arbitration clause in the agreement.

14 That arbitration clause states, "Any controversy,  
15 dispute, claim, or question arising out of or relating to  
16 this agreement, including, without limitation,  
17 interpretation, performance, or non-performance by any  
18 party, or any breach thereof, (hereinafter collectively  
19 "controversy") shall be referred to and resolved exclusively  
20 by three arbitrators through private confidential  
21 arbitration conducted in Philadelphia, Pennsylvania."

22 There's a mechanism for selecting the arbitration  
23 panel: "One arbitrator shall be chosen by each party, and a  
24 third by the two so chosen. If either party refuses or  
25 neglects to appoint an arbitrator within 30 days after

1 receipt of written notice from the other party requesting it  
2 to do so, the requesting party may choose a total of two  
3 arbitrators who shall choose a third. If those arbitrators  
4 fail to select a third arbitrator within ten days, after  
5 both have been named, the party plaintiff shall notify the  
6 American Arbitration Association, which shall appoint the  
7 third arbitrator," who shall be disinterested and neutral.

8 Further, "The arbitrators may abstain from  
9 following the strict rules of law and shall make their  
10 decision with regard to the custom and usage of insurance  
11 business as of the effective date of this agreement."

12 The ACE insurers contend in their motion that  
13 under applicable law the foregoing provision requires  
14 arbitration of the dispute regarding the debtors proposed  
15 breach of the applicable insurance program, and, as laid out  
16 on the record today by counsel for ACE, at least part of the  
17 issue relating to the cash collateral motion, which is what  
18 is the exact amount of the debtors' obligations that are  
19 secured under the applicable agreement.

20 The debtors contend, to the contrary, that the  
21 issue before the Court is not a breach of contract issue,  
22 but, rather, their right, whether or not the contract is  
23 breached by exercising such right, to use cash collateral  
24 pursuant to section 363(c)(2) of the Bankruptcy Code, which  
25 states that "The trustee" (and, for these purposes, a debtor

1 in possession is the equivalent of a trustee) "may not use,  
2 sell, or lease cash collateral under paragraph 1 of this  
3 subsection, unless (a) each entity that has an interest in  
4 such cash collateral consents, or (b) the court, after  
5 notice and a hearing, authorizes such use, sale, or lease in  
6 accordance with the provisions of this section."

7 The standard for such determination is set forth  
8 in Section 363(e) of the Bankruptcy Code, which states,  
9 "Notwithstanding any other provision of this section, at any  
10 time on request of an entity that has an interest in  
11 property sold, used, or leased, or proposed to be used,  
12 sold, or leased, by the trustee, the court, with or without  
13 a hearing, shall prohibit or condition such use, sale, or  
14 lease as is necessary to provide adequate protection of such  
15 interest."

16 "Adequate protection" is also referred to and  
17 defined, although, in a fairly open-ended way, in section  
18 361 of the Bankruptcy Code, which states that "when adequate  
19 protection is required under Section 363, it may be provided  
20 by," and then it lists several factors in the alternative,  
21 which have been supplemented by the case law.

22 At this point, following the leading decisions of  
23 *In re United States Lines, Inc.*, 197 F.3d 631 (2d Cir.  
24 1999), and *MBNA America Bank v. Hill*, 436 F.3d 104 (2d Cir.  
25 2006), the law regarding when and under what circumstances

1 arbitration is required in a bankruptcy case, and when, if  
2 it is not required, the Court should exercise its discretion  
3 to stay it, is fairly well defined in the Second Circuit.

4           The law is well summarized by Bankruptcy Judge  
5 Glenn in *In re Bethlehem Steel Corp*, 390 B.R. 784 (Bankr.  
6 S.D.N.Y 2008). He states, at 789, "When determining whether  
7 to compel arbitration and stay proceedings pending  
8 arbitration, a court must " (that is, the bankruptcy court  
9 in particular) "undertake a multi-step process: first, it  
10 must determine whether the parties agreed to arbitrate;  
11 second, it must determine the scope of that agreement;  
12 third, if federal statutory claims are asserted, it must  
13 consider whether Congress intended those claims to be non-  
14 arbitrable; and, fourth, if the court concludes that some,  
15 but not all, of the claims in the case are arbitrable, it  
16 must then decide whether to stay the balance of the  
17 proceedings pending arbitration." (quoting *Oldroyd v. Elmira*  
18 *Bank*, 134 F.3d 72, 75-76 (2d Cir. 1998).

19           When reading the case law, it is clear that in  
20 applying that analysis the courts are motivated or swayed in  
21 part by not just a simple determination of whether a matter  
22 is non-core or core pursuant to 28 U.S.C. section 157(b),  
23 although that is an important factor, but whether, even if  
24 it is core under that section of the Judicial Code, it is,  
25 in fact, "substantially" core or truly a function of the

1 bankruptcy process. They do so, I believe, in part because  
2 they are interpreting whether, in fact, the first factor is  
3 met, which is whether the parties agreed to arbitrate, and,  
4 also, whether the third factor is met, which is whether  
5 Congress intended the claims at issue to be non-arbitrable.

6 Bankruptcy is a multi-party process that is rooted  
7 in the past but that in many cases drastically alters the  
8 parties' prebankruptcy rights. It appears clear to me that  
9 using Judge Glenn's phrase "substantially core" from the  
10 Bethlehem Steel case, whether a debtor has authority to use  
11 cash collateral is clearly substantially core. That is, it  
12 is central to the bankruptcy process that Congress  
13 contemplated as substantially altering otherwise existing  
14 and enforceable rights under applicable non-bankruptcy law,  
15 and that Congress did so in light of the fact that it is a  
16 multi-party process, and not just a simple two-party  
17 dispute.

18 Many courts apply that analysis in the context of  
19 determining whether the parties actually agreed to arbitrate  
20 the dispute, making the distinction between the prepetition  
21 debtor and the postpetition trustee or debtor in possession.  
22 See, for example, Bethlehem Steel, 390 B.R. at 790 and 793,  
23 in which the court, citing many other authorities, holds  
24 that bankruptcy law-created claims that are not derivative  
25 of the prepetition debtor's rights are not subject to

1 arbitration. See also -- I appreciate it's the same judge,  
2 but the logic is the same, and equally telling -- In re S.W.  
3 Bach & Company, 425 B.R. 78 (Bankr. S.D.N.Y 2010), at 91  
4 through 92, as well as In re Salander-O'Reilly Galleries,  
5 LLC, 475 B.R. 9 (S.D.N.Y 2012), in which District Judge  
6 Seibel states, "There is no justification for binding  
7 creditors to an arbitration clause with respect to claims  
8 that are not derivative of one who is a party to it."

9 I recognize that Judge Lane in In re Cardali, 2010  
10 Bankr. LEXIS 4113 (Bankr. S.D.N.Y 2010), took the view that  
11 a fraudulent transfer lawsuit could be subject to  
12 arbitration, notwithstanding that the party in the shoes of  
13 the debtor in that case was asserting rights under the  
14 Bankruptcy Code created by Congress. He did so because,  
15 however, those rights specifically derived from state law  
16 causes of action, and his view regarding Granfinanciera,  
17 S.A. v. Nordberg, 492 U.S. 33 (1989). That view, frankly,  
18 conflicts with numerous other cases. I don't need to decide  
19 my own position on that issue, but it appears clear to me  
20 that congressional authority to use cash collateral under  
21 the requirements set forth in sections 363(e) and 361 of the  
22 Bankruptcy Code is not at all rooted in a right that exists  
23 pre-bankruptcy. Indeed, the whole purpose of the sections  
24 is to alter those rights, as created by Congress.

25 Therefore, it appears to me that with regard to



1 this particular dispute, the parties, in fact, did not agree  
2 to arbitrate the use of cash collateral. I say that  
3 notwithstanding my belief that it is a broad arbitration  
4 agreement, as phrased, and, therefore, would satisfy in  
5 favor of ACE (and certainly the debtors would not carry  
6 their burden to show otherwise) that the agreement is broad.  
7 But, to me, it does not deal with the unique bankruptcy  
8 context of the cash collateral motion.

9 One can also approach the problem presented by the  
10 motion from the perspective of whether Congress intended  
11 this particular type of dispute to be non-arbitrable.  
12 Obviously, Congress did not so state expressly in the  
13 relevant provisions of the Bankruptcy Code. On the other  
14 hand, Congress did expressly provide for the Court to make  
15 the relevant determination under section 363(e), and applied  
16 it to a trustee or debtor in possession, not the prepetition  
17 debtor.

18 And, further, it is, as such, a core matter going  
19 beyond the basic statutory definition of "core," 28 U.S.C.  
20 section 157(b), to be a fundamental aspect of the bankruptcy  
21 process. It is hard to see how Congress would have meant to  
22 turn over this particular type of determination, in which,  
23 as the Second Circuit has recognized, other parties in  
24 interest would have the right to intervene if they wanted to  
25 (see *In re The Caldor Corp.*, 303 F.3d 161 (2d Cir. 2002); 11

1 U.S.C. section 1109(b)) to an arbitration panel in a two  
2 party dispute, which may abstain from following the strict  
3 rules of law and "shall make their decision with regard to  
4 the custom and usage of the insurance business." See  
5 generally Randall G. Block, "Bound in Bankruptcy," 29 Los  
6 Angeles Lawyer (2007), in which the author states, "Other  
7 provisions of the Bankruptcy Code" (other than lift-stay  
8 motions) "that require the bankruptcy court to make findings  
9 or approve certain actions are arguably inconsistent with  
10 resolution through arbitration. For example, the  
11 confirmation of a plan, sale of property outside the  
12 ordinary course, use of cash collateral, or assumption or  
13 rejection of executory contracts all require express  
14 authorization by the court. Arguably this authorization  
15 requirement does not comport with allowing disputes over  
16 these matters to be handled through arbitration."

17 Again, all of those issues involve both multi-  
18 party notice and determination, recognizing the multi-party  
19 nature of bankruptcy issues in bankruptcy cases, and,  
20 finally, in a summary proceeding manner, the exercise, as a  
21 final call, of the bankruptcy judge's judgment as to the  
22 propriety of the action to be taken. See *In re Orion*  
23 *Pictures Corp.*, 4 F.3d 1095 (2d Cir. 1993).

24 It also appears to me that even if the arbitration  
25 provision does, in fact, apply to this dispute, the Court

1 should exercise its discretion and deny the arbitration  
2 demand. The Court clearly has that authority, given that  
3 this is a core proceeding. The cases stemming from the MBNA  
4 v Hill decision make that clear, as does the United States  
5 Lines decision, although MBNA also made it clear that to  
6 exercise the court's discretion on a core matter, that is,  
7 core under 28 U.S.C. section 157, the type of matter must be  
8 unique to or uniquely affected by bankruptcy proceedings,  
9 and the proceedings are a core bankruptcy function that  
10 invokes substantial substantive rights that are created by  
11 the Code and in severe conflict with arbitration under the  
12 Federal Arbitration Act.

13 As I noted earlier, this is clearly that type of  
14 proceeding. Therefore, I see no contradiction in the logic  
15 employed by Bankruptcy Judge Walsh in Delaware in the NEC  
16 Holdings' case, which involved a similar request for cash  
17 collateral (the transcript of which has been attached as  
18 Exhibit B to the objection of the motion, which is Case No.  
19 10-1890, Docket No. 1360, Bankruptcy D. Delaware, June 30,  
20 2011), and Judge Walsh's written decision in In re Olympus  
21 Healthcare Group, 352 B.R. 603 (Bankr. D. Del. 2006), which  
22 involved not use of cash collateral, but a contract dispute,  
23 a true contract dispute, which certainly would be subject to  
24 arbitration.

25 If I were to exercise any discretion here, I

1 believe it would not be over whether I should hear the  
2 section 363(e) matter, because clearly I need to hear it, I  
3 have a duty to hear it, but, rather, whether I should parcel  
4 out a piece of that litigation to an arbitration panel.  
5 But, as I stated during oral argument, it would seem to me  
6 that that piece would only be a piece to fix a specific fact  
7 that might be at issue, as opposed to underlying rights of  
8 the parties.

9           It would be analogous to compelling a piece of a  
10 lift stay motion to go to arbitration, and then have that  
11 fact come back to me. I suppose under certain  
12 circumstances, applying the Second Circuit's factors laid  
13 out in *In re Sonnax*, a court might do that, particularly if  
14 the non-bankruptcy tribunal or arbitrable panel was about to  
15 rule on that key issue. See *In re Sonnax Industries, Inc.*,  
16 907 F.2d 1280, 1286 (2d Cir. 1990), laying out the twelve  
17 factors that the Circuit believes relevant to whether to  
18 lift the stay for another decision-making body to determine  
19 an issue.

20           But it would be in that context, as opposed to  
21 requiring arbitration, and it is the approach that has been  
22 taken by countless courts in the analogous situation where  
23 there was a lift-stay motion and parts of the issue were  
24 involved in arbitration and where the courts applied the  
25 *Sonnax* factors as opposed to saying that pieces of the lift

1 stay issue were to be sent to the arbitrators. See, for  
2 example, *Salander-O'Reilly Galleries*, 479 B.R. at 25; *In re*  
3 *St. Vincent's Catholic Medical Centers of New York*, 2012  
4 U.S. Dist. LEXIS 139584 (S.D.N.Y September 27, 2012), at 8  
5 through 10; and *In re Quigley Company, Inc.*, 361 B.R. 723,  
6 743 through 44 (Bankr. S.D.N.Y 2007). See also *In re*  
7 *Spectrum Information Technologies, Inc.*, 183 B.R. 360  
8 (Bankr. E.D.N.Y 1995), although I recognize that that case  
9 predates *MBNA v Hill*.

10 I conclude, in exercising my discretion with  
11 respect to this core matter under 28 U.S.C. section  
12 157(a)(2) (and it is "substantially" core under the  
13 arbitration/bankruptcy court analysis), that the issues,  
14 which substantially affect both bankruptcy policy as well as  
15 the conduct of this case, are such that even if the parties  
16 did, in fact, agree to arbitrate the cash collateral issue,  
17 and, further, that Congress did not intend to preclude the  
18 arbitration of this issue, having considered the nature of  
19 the claim and the facts of this case, clearly the whole  
20 dispute (and even the portion of dispute which would not  
21 result in anything more than providing a data point for the  
22 Court in deciding the dispute), should not be determined by  
23 an arbitration panel.

24 To do so would seriously jeopardize the objectives  
25 of the Bankruptcy Code as expressed in section 363(c) and

1 (e) and conflict with the integrity of the bankruptcy  
2 process in this case. So I'll deny the motion. The debtors  
3 can submit an order, and they should e-mail a copy of it to  
4 counsel for ACE before they submit it, to make sure it's  
5 consistent with my ruling.

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7 **Dated:** White Plains, New York  
January 7, 2013

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/s/Robert D. Drain  
**UNITED STATES BANKRUPTCY JUDGE**

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